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State of California

Board of Equalization

Memorandum

To : Mr. T. P. Putnam

Date: September 5, 1968

1) increase in value
2) change in original form
3) substantial amount of labor

From : Lawrence A. Augusta

Subject: Substantial Change in Form of Restaurant Equipment Leased by Franchise Owner

The question has been raised whether the management of a restaurant chain can purchase individual items of restaurant equipment such as dishes, utensils, pots and pans, etc., on a tax-paid basis, assemble them into a working unit, namely an operating restaurant, lease the unit as a whole to a franchise operator on a percentage lease, and still retain the tax-paid status. Audit staff personnel of the Board believe the subsequent rental receipts may be subject to sales tax on the grounds that the process of assembling the equipment into a "unit" results in such a substantial change in the form of the individual items of equipment that the lease no longer comes within the exception of Revenue and Taxation Code section 6006(g)(5) and ruling 70(E).

This appears to be a question of first impression.

The general rule has been stated to be that if the value of the property as leased is substantially in excess of the purchase price of the property or its components, then the item is not leased in substantially the same form as acquired. The rule seems to be based on the assumption that the increase in value results from the fabrication involved in the assembly or construction process, and the tax on rentals then is an attempt to tax this increased value.

This "increase in value" theory has been the principal test applied to the various fact situations arising, though often in a negative sense and sometimes in conjunction with a secondary rule based on the amount of labor and the extent of the changes necessary. The latter rule appears to be concerned with those cases in which the components may be of little functional value separately; and even though the assembly results in no substantial increase in the final monetary value over the value of the components, the components cannot be used for the lessee's purposes without being assembled. In this regard there have also been attempts to establish a rule of thumb based on the percentage the labor cost bears to the total cost of the components or value of the end product.

These "rules" have been applied by the legal staff to various fact situations with varying results. Consider the ruling that an individual is not subject to tax when, pursuant to an agreement to lease trucks with bodies, he leases a new chassis to be combined with the old body when the old chassis wears out. Without mentioning the possible increase in value of the unit as the result of the assembly process, it was concluded that the process of exchanging chassis was so simple no substantial fabrication labor was involved; and consequently, there was no substantial change in form.

Compare the truck chassis case with the ruling that the addition of a "side shifter" to a leased fork lift truck resulted in a substantial change in form. The amount of fabrication labor was not mentioned, and the ruling was based on the increase in the value of the truck and the resulting increase in rental charge. The ruling also considered the increase in capabilities of the lift truck as a result of adding the side shifter. It may be that adding the side shifter was no more complex a project than exchanging the chassis, but this was really ignored in face of the increased fee and value.

Another ruling states that a boat and motor separately purchased tax paid will not be substantially changed if all that is necessary is to bolt or clamp the motor in place on the boat, but will be substantially changed if it is necessary to alter the boat to accommodate the boat through drilling holes, wiring, installing controls, etc. Would the boat and motor combination have more value as a rental if the motor were attached through a process of drilling, wiring, etc., than it would if only clamping were necessary? It might, if what we are comparing is a 10-foot rowboat and 5 h.p. outboard motor with a 16-foot ski boat and 40 h.p. outboard--with front end steering, remote controls, electric starter, etc., the ski boat would undoubtedly rent for more and the fabrication labor would have created this increase--but it is not clear from the opinion that this was considered.

A similar, but more clear-cut case, involved the separate purchase tax paid of skis and ski bindings. It was ruled that attaching the bindings to the skis so they were ready to rent was not a substantial change in form. By all tests, this result is probably correct. No significant amount of labor is involved in the simple process of attaching the bindings, no change in form or function is involved, and it would seem no measurable increase in value resulted.

Another relatively clear-cut case involved an individual engaged in the rug rental business. He purchased carpeting in rolls and converted it to rugs, probably of varying sizes. Here the process of cutting and binding probably involved a fair amount

of fabrication labor, and the value of the carpeting undoubtedly increased as a result of the fabrication. Both labor and increase in value, then, are present here.

Finally, consider the case of the lessor of decorative trees and plants. Consistent with the motor boat and ski cases, it was ruled that affixing a simple base to a tree through a simple process did not result in a substantial change in form. One difficult problem in this case lay, however, in those trees and plants which stood unrented and grew in height and foliage in the intervening period. Here was a situation which involved no fabrication labor (unless the usual watering, etc., would be so classed) and yet the increase in rental value was used to support a finding that the growth of the trees was a substantial change in form.

In the tree case, tax counsel proposed a rule of thumb that the change would be considered substantial if the growth increased the value 20 percent. This element was also considered in other cases. In the boat-motor case, it was proposed that the test should be whether the cost of the labor involved in assembly exceeded 10 percent of the cost of the boat and motor. In the "side shifter" case it was considered significant that the increase in value was actually 15 to 20 percent rather than 5 to 10 percent as stated by the taxpayer. These percentages may be helpful guides, but the disagreement on the figure detracts from their usefulness.

This rather lengthy discussion has been presented to illustrate that it is probably possible to reach whatever conclusion is desired in the present lease of restaurant equipment situation. Arguments can be made to support taxation of rental receipts as well as to support taxation only on the purchase price. The question is really administrative rather than legal; and if the Board wishes to enter into taxation based on a substantial change in form, I believe it can be supported by code and precedent.

In my opinion the better rule would be that there is no substantial change in form. Organizational efforts involved in developing and equipping individual locations in a restaurant chain do not seem to be equivalent to fabrication labor involved in creating rugs from roll carpeting. The act of purchasing all necessary equipment is not the same as attaching a side shifter to a fork lift truck. There has been no change of physical form, and the process of overseeing assembly of the equipment into a unit is relatively simple.

I can see no increase in value in the same sense as the growth of the trees and plants or the addition of a side shifter

which will allow a fork lift to move loads in a different manner from before. The physical parts of the unit remain separate and distinct while retaining their original form. There is no physical addition or increase in value of each item, in fact, they probably could be extracted and leased separately for as much or more than their proportionate share of the total lease. The real value in the assembly process comes from development of the chain and its goodwill, and this management function is more in the nature of a service than anything else.

LAA:ph

cc: Downey - Subdistrict Administrator

ADDENDUM TO MEMORANDUM

Substantial Change in Form of Restaurant
Equipment Leased by Franchise Owner

Perhaps this whole discussion of substantial change is moot for another reason. The franchise operator is a retailer of meals, liable for tax measured on gross receipts from the sale of the meals. The total price of the meal includes some amount, even though not separately stated, for the use of utensils and other equipment--they are consumed with the meals, and the tax on the meal is also a tax on the use of the equipment. Thus, it could be concluded that the lease of the equipment to the franchise holder is not a sale at retail since it is for the purpose of resale (or sublease). Perhaps this is similar to the purchase by a restaurant of ice solely for sale with food or drinks, which was held to be a sale for resale. This may be subject to question, however, since paper tablecloths have been ruled taxable since used by the restaurant rather than the customer, whereas paper napkins and place mats were sold for resale since used by a patron and sold with the meal.

LAA:ph